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No. 79-1947

In the Supreme Court of the United States

OCTOBER TERM, 1979

STEPHAN SCHAFFAN AND MILDRED SCHAFFAN,
PETITIONERS

v.

COMMISIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The question presented in this federal income tax case is whether the decision below correctly held that the transfer of assets of Fletcher Plastics, Inc. to Atlas Tool Company, Inc. (both of which were wholly owned by petitioner) followed by the liquidation of the former corporation, constituted a reorganization within the meaning of Section 368(a)(1)(D) of the Internal Revenue Code of 1954 (26 U.S.C.).

The pertinent facts may be summarized as follows: Petitioner Stephan Schaffan[1] was the sole shareholder of Fletcher Plastics, Inc. and of Atlas Tool Company, Inc. The business of both corporations related almost

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[1]Mildred Schaffan is a party solely because she filed a joint return with her husband for the year at issue.

exclusively to the hobby industry, principally model railroads. Fletcher manufactured parts for model trains, and sold those parts to Atlas. The equipment used by Fletcher to manufacture the parts was located in a building otherwise occupied by Atlas. Atlas assembled and sold parts it had obtained from Fletcher and from others, including foreign suppliers (Pet. App. 3a-4a).

In 1970, petitioner decided to eliminate Fletcher, and to transfer its operating equipment to Atlas. He decided that Atlas could rely upon less expensive foreign supplies, but that the Fletcher equipment should be retained in reserve in case outside supplies proved inadequate or defective (Pet. App. 12a). In October 1970, at directors' and shareholders' meetings, Fletcher voted to liquidate pursuant to Section 337 of the Code. On November 5, 1970, Fletcher transferred to Atlas its machinery, and received the appraised value of $100,250. On November 19, 1970, petitioner received a cash distribution in the amount of $482,246 from Fletcher that constituted all of its assets. Fletcher was formally dissolved in June 1971 (Pet. App. 4a-5a).

On petitioner's 1970 federal income tax return, he reported $400,000 as a distribution from Fletcher in complete liquidation under Section 331 of the Code, resulting in a $390,000 long-term capital gain in excess of his $10,000 basis in the Fletcher stock (Pet. App. 5a). On audit, the Commissioner of Internal Revenue determined a deficiency on the grounds that the amount distributed by Fletcher was $482,246.82, rather than $400,000, and that the transaction between Fletcher and Atlas constituted a reorganization under Section 368(a)(1)(D) of the Code, so that the distribution received by petitioner from Fletcher should have been treated as a dividend under Section 356(a)(2) to the extent of the corporation's earnings and profits (Pet. App. 5a-6a).

In this proceeding brought by petitioner for redetermination of the deficiency, the Tax Court upheld the Commissioner. It found that the amount distributed by Fletcher was $482,246.82, that the transaction between Fletcher and Atlas constituted a reorganization under Section 368(a)(1)(D), and that the distribution received by petitioner from Fletcher should have been treated in accordance with the provisions of Section 356(a)(2) (Pet. App. 42a-56a). The court of appeals affirmed (Pet. App. 82a-83a).

1. The decision below correctly held that the transaction between Fletcher and Atlas constituted a reorganization under Section 368(a)(1)(D) of the Code. The courts have uniformly held that the transfer of all of one corporation's operating assets to another corporation controlled by the sole shareholder of the transferor (here Fletcher) meets all of the requirements of Section 368(a)(1)(D), together with the added requirements in Section 354(b)(1).[2]

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[2] *Ringwalt* v. *United States*, 549 F.2d 89 (8th Cir. 1977); *DeGroff* v. *Commissioner*, 444 F.2d 1385 (10th Cir. 1971), aff'g 54 T.C. 59 (1970); *Abegg* v. *Commissioner*, 429 F.2d 1209 (2d Cir. 1970), cert. denied *sub nom. Cresta Corp., S.A.* v. *Commissioner*, 400 U.S. 1008 (1971); *Babcock* v. *Phillips*, 372 F.2d 240 (10th Cir.), cert. denied, 387 U.S. 918 (1967); *Davant* v. *Commissioner*, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967); *Moffatt* v. *Commissioner*, 363 F.2d 262 (9th Cir. 1966), cert. denied, 386 U.S. 1016 (1967); *Commissioner* v. *Morgan*, 288 F.2d 676 (3d Cir.), cert. denied, 368 U.S. 836 (1961); *Pebble Springs Distilling Co.* v. *Commissioner*, 231 F.2d 288 (7th Cir.), cert. denied, 352 U.S. 836 (1956); *Liddon* v. *Commissioner*, 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956); *Becher* v. *Commissioner*, 221 F.2d 252 (2d Cir. 1955); *Bard-Parker Co.* v. *Commissioner*, 218 F.2d 52 (2d Cir. 1954), cert. denied, 349 U.S. 906 (1955); *Lewis* v. *Commissioner*, 176 F.2d 646 (1st Cir. 1949); *Survaunt* v. *Commissioner*, 162 F.2d 753 (8th Cir. 1947).

Petitioner does not contest that the transaction met all explicit statutory requirements for a reorganization. He nevertheless argues (Pet. 6-7) that the transaction should not be regarded as a reorganization because he had no tax avoidance motive. But such a contention stands the law of reorganization transactions on its head. It has often been said, following this Court's decision in *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935), that a business purpose is required in order to have a reorganization. See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* para. 1.05 & 14.51, at 1-20, 14-127, 14-129 (4th ed. 1979). This conclusion is consistent with the legislative history of the reorganization provisions of the Code, which were enacted to facilitate business transactions (S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921); H.R. Rep. No. 179, 68th Cong., 1st Sess. 13 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 14-15 (1924), and has long been reflected in the Treasury Regulations. See Treasury Regulations on Income Tax, Sections 1.368-1(b) and 1.368-2(g) (26 C.F.R.). Petitioner does not question that there was a business purpose for the transaction involving Fletcher and Atlas. In view of the undisputed fact that the transaction met the statutory definition of a reorganization and had a business purpose, there is no rational basis for holding the statute inapplicable simply because petitioner may have been innocent of any tax avoidance motivation.

Contrary to petitioner's argument (Pet. 6), the decision below does not conflict with either *Pridemark, Inc.* v. *Commissioner*, 345 F.2d 35 (4th Cir. 1965), or *Reef Corp.* v. *Commissioner*, 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967). In some cases, such as *Reef Corp.*, rather elaborate schemes for tax avoidance were apparent. The decision in that case did not turn upon the presence of a tax avoidance motive. To the contrary, the transaction in *Reef Corp.* constituted a reorganization

because it met the relevant statutory requirements. On the other hand, in *Pridemark Corp.*, the transaction did not constitute a reorganization because the original corporation's business assets were sold to an unrelated corporation, and its other assets were distributed to its shareholders. Moreover, there was no plan to continue the business. Hence, even apart from the disposition of operating assets to an unrelated corporation, there was no "plan of reorganization" as required by Section 354(a)(1).

3. The court of appeals also found that the transaction here satisfied the nonstatutory continuity of business enterprise requirement for a reorganization (Pet. App. 12a-13a). Although Atlas temporarily suspended the operation of the equipment obtained from Fletcher, Atlas retained Fletcher's operating assets to use in the event Atlas could not obtain the parts it needed from other suppliers. Within four months after the transaction, Atlas placed some of the machinery in operation and within a year all of it was utilized to make the same products that Fletcher formerly produced (Pet. App. 12a). The continuity of business enterprise requirement does not impose a requirement of identity; the continued business does not have to be an exact replica of the business conducted by the transferor. *Becher* v. *Commissioner*, 221 F. 2d 252, 254 (2d Cir. 1955); *American Bronze Corp.* v. *Commissioner*, 64 T.C. 1111, 1123-1124 (1975). The business enterprise that Atlas conducted took over the equipment previously operated by Fletcher and used it in

the fashion it believed to be most advantageous. The continuity of business enterprise requirement was therefore fully satisfied (Pet. App. 12a).[3]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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[3]None of the cases upon which petitioner relies (Pet. 7) are inconsistent with the decision below. In *Lewis* v. *Commissioner*, 176 F.2d 646 (1st Cir. 1949), the transferee corporation continued only one of the transferor's three businesses, but the court found that the continuity of business enterprise requirement was satisfied. In *Reef Corp.*, *supra*, and *Ringwalt* v. *United States*, 549 F.2d 89 (8th Cir. 1977), the courts found that the transactions in issue constituted reorganizations. The continuity of business enterprise requirement was not directly in issue in those cases, and they do not reflect an interpretation of that requirement at variance with the decision in the instant case.

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